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C O N F I D E N T I A L SECTION 01 OF 03 MOSCOW 003886

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TAGS: [ECON](#) [EIND](#) [ENRG](#) [PREL](#) [RS](#)
SUBJECT: RUSSIA: NEW STRATEGIC SECTORS LAW GETS NOD FROM
PRIVATE SECTOR

REF: MOSCOW 3650

Classified By: ACTING ECON M/C KATHLEEN DOHERTY. REASONS 1.4(b/d)

11. (SBU) SUMMARY. During a July 14-20 visit to Moscow, a GAO (Government Accountability Office) delegation conducted meetings with government officials (reftel), business associations, and Western companies to survey the GOR's review process for foreign direct investment in the country's strategic sectors. The delegation met with representatives from the Western business community that included: the American Chamber of Commerce, the Foreign Investment Advisory Council, Alcoa, Dupont, General Motors, BP, and ConocoPhillips. Common themes of all meetings included: GOR regulatory institutions are still in their early development stages; passage of the Strategic Sectors Law (SSL) would fill a legislative vacuum and are viewed in a positive light; the law could increase transparency and predictability to the process, but it remains to be seen as to how the law will be implemented; and the energy sector is only peripherally following the SSL because oil and gas have been taken out of the SSL and treated separately in amendments to the Sub-soil Laws. These meetings were conducted under GAO's assurances of confidentiality to ensure a frank discussion so please protect accordingly. END SUMMARY.

BACKGROUND

12. (SBU) The Senate Banking Committee requested that GAO provide a descriptive report as to how other countries regulate foreign direct investment into "strategic sectors." The report, expected to be published in January 2008, will update a 1990 report that surveyed other countries' procedures that are similar to our own CFIUS (Committee For Foreign Investment in the U.S.) process. The delegation chose to conduct research on 10 countries, which included in-country visits to five countries: Canada, China, Germany, E.U.(Brussels), and Russia. On July 17, the GOR sent the draft Strategic Sectors Law to the Duma.

BUSINESS ASSOCIATIONS

13. (SBU) In a July 16 meeting, American Chamber of Commerce President Andrew Somers gave the GAO delegation an overview of the current investment climate in Russia for foreign

companies. Somers' main point was that the GOR was just starting to grasp the idea that regulatory environment affects foreign investment. Going through a list of issues that AMCham has recently engaged with the GOR, such as work permits for foreign workers and disallowing exemptions of royalty payments, Somers characterized Russian regulatory practices as immature, but improving. When institutions are weak, personalities who head institutions become more important and can shape policies and the implementation of regulations. As an example of progress in institution-building, he cited improvements in the court system. According to Somers, companies win 70 to 80 percent of court cases brought against the government.

14. (SBU) Chairman of the Foreign Investment Advisory Council (FIAC) Karl Johansson said that FIAC meets on a regular basis with the GOR, the PM's office and the Ministry for Economic Development and Trade. According to Johansson, the GOR has been extremely open in working with FIAC on issues that concern its members. FIAC members have not had a reason to go through a review process so far because most work in the retail sector. In general, FIAC members think the new law will provide a process and clarify the rules. Of course there is still uncertainty as to how the law will be implemented. Comparing Russian and Chinese business environments, Johansson said that he believes Russian companies are more transparent and the rate of return is greater in Russia. Since institutions are still, however, very weak in Russia companies need to do much of the due diligence themselves. Business associations do not view the SSL as a harsh protectionist policy. The general view is that the GOR has the right as any other government to create a framework to protect its national security.

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INVESTMENT IN PRACTICE

15. (C) In a July 17 meeting, Alcoa Russia President Bill O'Rourke said that Alcoa managed to acquire two aluminum fabricating facilities that conducted work for the military even without a formal SSL to govern the process. According to O'Rourke, the single most important factor as to why Alcoa received approval is the company's reputation. (NOTE: After a seven-month process, Alcoa received government approval in early 2005 to acquire two rolling/casting facilities in Samara and Belaya Kalitva. END NOTE.) Another important factor was lobbying by the Ministry of Economic Development and Trade (MEDT) in the Kremlin. Both Minister Gref and Deputy Minister Androsov "went out on a limb" to give Alcoa a chance to turn these plants around. During the entire approval process, the MEDT and the FAS were Alcoa's main points of contact with the government. When asked about the new SSL, O'Rourke said that Russian law is generally very good and the SSL would bring some consistency to the process. However, the problem is that the law is inconsistently applied.

16. (SBU) GM General Director Heidi McCormick provided a broad perspective on the difficulties of "brownfield" investments in Russia, i.e., foreign acquisition of existing facilities. In addition to the assets, the foreign owner also inherits the liabilities of the former operations, such as environmental hazards. GM operates a joint venture in Togliatti with Avtovaz and is building a "greenfield" plant, i.e., a new factory built from scratch, in St. Petersburg. According to McCormick, whereas GM's current activities would not be governed under the pending SSL, the law would help improve the current ad hoc nature in which decisions are made about foreign investment in the "strategic sectors." When asked about other regulatory measures that affect GM's activities, she said that the "greenfield" project required certification of the facility and the product.

17. (SBU) Dupont Financial Director Elena Kirisova told us

that her company's 2005 acquisition of a chemical plant in Nizhny Novgorod that produces paint/coating material did not undergo any review process. The new competition law, passed last Fall, does not require a review by the FAS if the deal does not involve a significant market share. When asked about the pending passage of the SSL, Kirisova said that the law should not affect Dupont's business since their main line of business, chemical products and fertilizers, are not covered under the SSL. According to Kirisova, business is booming and the construction of foreign automobile assembly plants in the St. Petersburg region is requiring Dupont to open a branch office in St. Petersburg.

ENERGY IS DIFFERENT

18. (SBU) In a July 18 meeting with Petroleum Advisory Forum President Vladimir Konovalov, the GAO delegation received a good overview of the difficult investment climate for energy companies in Russia. He reviewed the evolution of the Kremlin's policy towards foreign energy companies doing business in Russia. In today's environment, Gazprom and Rosneft are Kremlin tools with decisions being made by one man, i.e., Putin. The Kremlin has also implicitly given these two companies control over the off-shore oil and gas reserves. Oil and gas have been in and out of the SSL, but now it seems as if they are out again. (BEGIN NOTE: In the January draft of the SSL, the GOR removed investment in "strategic" mineral deposits from the list of activities governed by the SSL and put them into separate amendments to the Sub-soil legislation. These amendments are still under government review and were not submitted, with the draft law, to the Duma on July 17. END NOTE.)

19. (SBU) BP and ConocoPhillips told the GAO delegation that they are only peripherally following movement of the SSL through the government since the oil and gas sector has been taken out of the law. The general perspective seems to be that these laws are secondary in importance to a good working

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relationship with the Kremlin.
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